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MEMORANDUM FOR: See Distribution List

FROM :
Acting Chief, Economics Division, OGI

25X1

SUBJECT : Medium-Term Foreign Trade Outlook for
South Korea

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Attached is a typescript recently produced by the Economics Division at the request of George Payne, Desk Officer, East Asia and the Pacific Division, Department of Commerce. If you have any questions or comments, please contact our
International Trade Branch
Northeast Asia Division, Office of East Asian Analysis

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Attachement:
GI M 86-20050, February 1986

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SUBJECT: Medium-Term Foreign Trade Outlook for South Korea

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13 February 1986

South Korea: Medium-Term Outlook for Exports and Import CapacitySummary

South Korea strongly depends on foreign trade to fuel its domestic economy; a substantial part of GNP growth can be attributed to higher exports, and many crucial industrial inputs are imported. After a poor performance last year, we forecast higher growth of real exports, real imports, and real GNP over the 1986-90 period. However, growth rates will still be well below the average for 1970-84. Lower economic growth and continued high unemployment could unite student and labor dissidents and make it more difficult for Seoul to carry through plans for trade liberalization with the United States. Despite this, we do not believe that economic issues will provoke a dramatic confrontation between the Korean government and opposition groups. However, should export growth remain low, due to a recession in developed countries, the domestic situation likely would become more troublesome.

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This memorandum was prepared by [redacted] International Trade Branch, Office of Global Issues with a contribution from [redacted] Northeast Asia Division, Office of East Asian Analysis. This analysis is based on information received as of 5 February 1986. Comments and queries may be addressed to the Chief, International Trade Branch, OGI [redacted] or Chief of Korean Branch, OEA [redacted]

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SOUTH KOREA: MEDIUM-TERM OUTLOOK FOR EXPORTS AND IMPORT CAPACITY

Background

South Korea strongly depends on foreign trade to fuel its domestic economy; over one-third of overall GNP growth during the past fifteen years can be attributed to higher exports. During 1970-79 export earnings increased an average 37 percent annually, with real exports up 25 percent per annum. This powerful export performance fueled strong import and real GNP growth, with the latter rising nearly 10 percent per year during that period. However, between 1980 and 1984 export increases slowed considerably, with gains only half as large as during 1970-79 (figure 1). This forced a slowdown in the pace of import growth, in turn contributing to a sharp reduction in the average real GNP growth rate. [REDACTED]

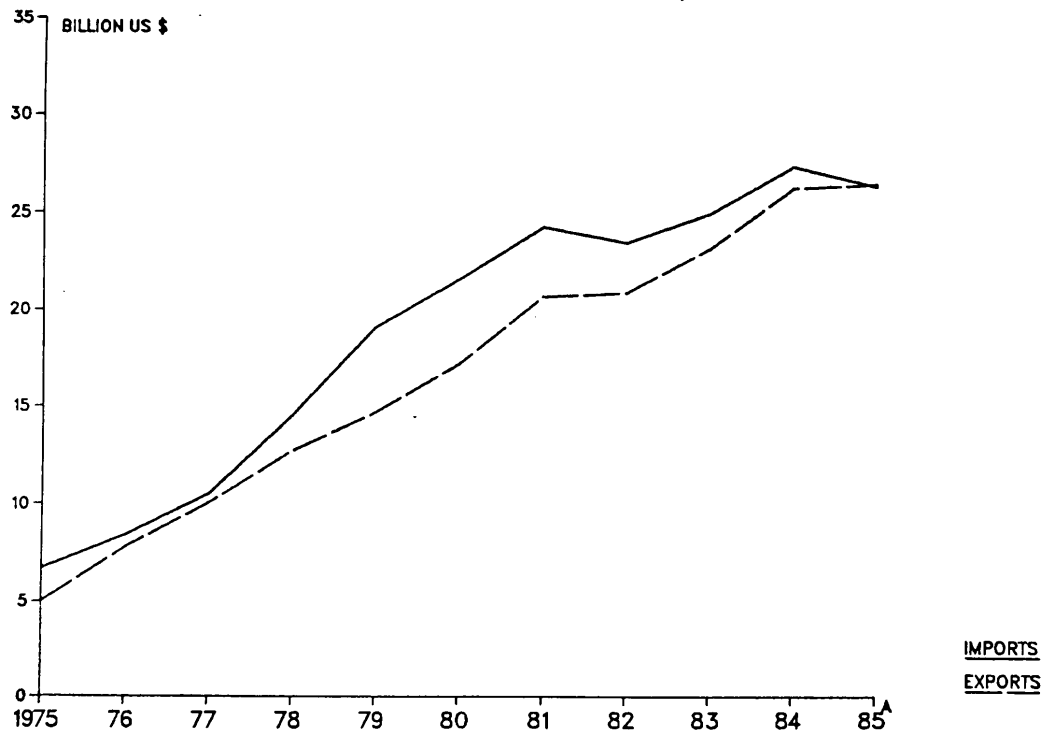
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Slower export growth was accompanied by an explosive increase in external debt (particularly short-term), as Seoul tried to avoid the adverse domestic impacts of high oil prices and large fiscal deficits in the late 1970s and early 1980s. As a result, total debt has risen to an estimated \$46 billion in 1985--a three-fold increase since 1978--and is now the fourth largest among developing countries. While the pace of debt accumulation slowed in recent years, it accelerated to over 7 percent in 1985 as concern over the slowing economy led to

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FIGURE 1

SOUTH KOREA: EXPORTS AND IMPORTS, 1975-85



A. ESTIMATED.

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increased government pump-priming and extension of trade credits. [REDACTED]

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[REDACTED]

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Low Export Growth in 1985

South Korean export growth slowed dramatically in 1985. Based on data from the first three quarters of the year, we estimate that export earnings increased less than 1 percent, a sharp reduction from the 20 percent increase recorded in 1984 and the smallest export gain since 1958. Three factors have contributed to the export slowdown:

--Slowing growth of OECD real GNP has reduced the growth of import demand. Lower economic growth is most evident in the United States--South Korea's largest export market-- where real GNP growth was about 2 1/2 percent in 1985, compared with nearly 7 percent the previous year. Real GNP growth also slowed in Japan, which is South Korea's second-largest export market.

--Lower export prices, due to weakening demand, greater competition, and Seoul's aggressive devaluation of the won, sliced South Korean export earnings last year. We estimate that export prices declined 7 percent, compared with a 4-percent drop in 1984.

--Increased trade protectionism reduced South Korean export revenue. As of February 1985, twenty industrialized countries

[REDACTED]

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were applying restrictions against South Korean exports, ranging from anti-dumping measures to import quotas to voluntary export restraints. Restrictions were intensified last year in the traditionally protected sectors and introduced for new areas. Anti-dumping duties were imposed by Canada on certain steel products, voluntary export restraint was maintained on steel exports to the United States, and quotas were imposed by France on quartz watches. While the impact of these measures on Korean exports is difficult to quantify, the South Korean authorities estimate the cost to be \$1 billion in lost export earnings in 1985.

Sales to the United States and West Germany fell, while exports to Canada, Japan, and the United Kingdom increased (table 1). Exports of manufactures declined slightly, while exports of foodstuffs (mostly fish, fruits, and vegetables) and raw materials fell sharply. Foreign sales of fuels (mostly petroleum products) showed a strong increase.

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Stronger Export Growth in the Medium Term¹

Over the medium term the pace of export growth should increase. Under our baseline scenario, we forecast an average annual 13 percent increase in export earnings during 1986-90, with real (inflation-adjusted) export gains averaging just over 9 percent per

¹

Our assessment of South Korea's medium-term export prospects is based on an econometric model of South Korean exports. See the appendix for a description of the model and the export scenarios.

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Table 1
 South Korea Exports: First Three Quarters 1984-1985

Million US \$

Exports by Country

	<u>1984</u>	<u>1985</u>	<u>Change (percent)</u>
Total	20,990	20,760	-1
Of which:			
United States	7,940	7,627	-4
Canada	655	893	36
Japan	3,236	3,254	1
United Kingdom	644	658	2
West Germany	675	618	-8

Exports by Commodity Group^a

	<u>1984</u>	<u>1985</u>	<u>Change (percent)</u>
Foodstuffs	816	709	-13
Raw Materials	142	128	-10
Fuels	347	441	27
Manufactures	11,251	11,149	-1
Other	149	98	-34

^aDue to data limitations, based on partner country data from the United States, Canada, France, Japan, the United Kingdom, and West Germany.

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year. However, real export growth will remain well below the pace recorded during 1970-84. [REDACTED]

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Three factors will have a positive influence on exports:

--Real exchange rate depreciation. South Korean exchange rate policy is geared toward balance of payments objectives, and we believe the authorities will allow the real (price-adjusted and trade-weighted) exchange rate to depreciate at a moderate pace (about 3.5 percent per year) to improve export competitiveness in the face of increasing competition from other Asian countries.

--Higher export prices. South Korean export prices have fallen every year since 1981, cutting the growth of export earnings, and we forecast an additional 1 percent drop in 1986. However, export prices should begin to rise after this year as steady economic growth in the major industrialized countries, combined with the expected real exchange rate depreciation, boosts demand for manufactured goods. However, competitive pressures will keep price increases modest, on average about 4.5 percent per year during 1987-90.

--Export promotion programs. In addition to exchange rate devaluation, Seoul has implemented other measures to enhance the competitiveness of South Korean goods. These include simplified export procedures, favorable export financing, increased loans to

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small- and medium-sized firms for export facilities, and providing funds to the textile industry for modernization. These steps should improve exporters' efficiency and increase export revenue over the medium-term.

Continued moderate real GNP growth in developed countries will underpin higher South Korean export growth. Under our baseline scenario, we assume real OECD income growth of 3 percent annually during 1986-90, about the same pace as last year. Higher real GNP implies continued growth of import demand in industrialized countries, which should in turn boost South Korean exports.

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Finally, while the South Korean export sector continues to be dominated by manufactured goods, substantial progress has been made to reduce dependence on light manufactures and instead increase exports of chemicals, electronics, iron and steel products, ships, machinery, and other transport equipment² (figure 2). For example, South Korea now provides a significant portion of the United States' consumer electronics market under brand names such as Gold Star and Savin; Hyundai Motors will begin marketing its Pony subcompact car in the United States later this year. South Korea's rapid climb up the technology ladder should continue, a trend that should boost the importance of technology-intensive products in the export mix. This greater diversification could lead to higher export earnings over the next five years.

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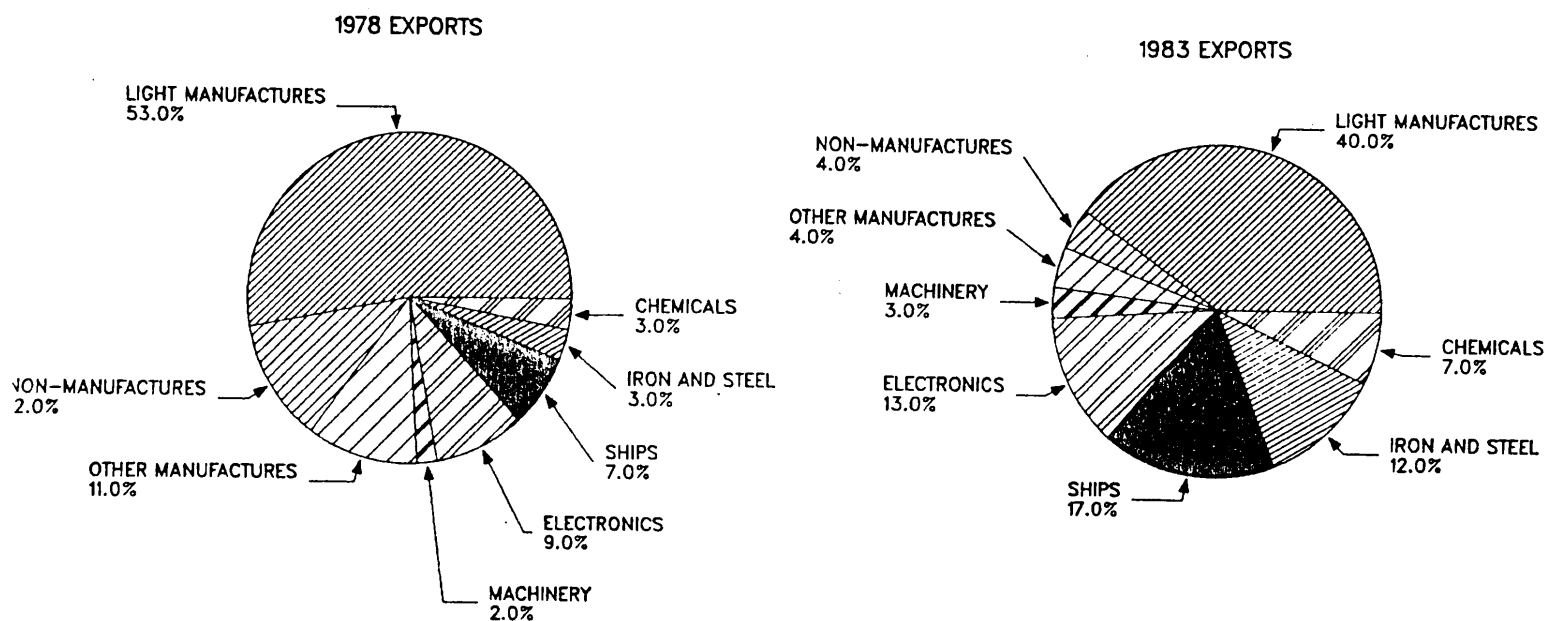
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In some light manufacturing industries, such as textiles, efforts are underway to improve efficiency and maintain competitiveness.

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FIGURE 2
SOUTH KOREAN EXPORTS BY COMMODITY



There are two powerful factors that could limit future export gains, however; industrial country protectionism and competition from other Asian nations. South Korea is vulnerable to protectionist measures, particularly from the United States. Over 35 percent of total exports go to the United States, and Korea runs a \$4 billion trade surplus with the United States. In some industries, such as textiles, steel, and footwear, South Korea has made substantial inroads into the US market, and further trade friction has arisen in the areas of intellectual property rights, computer software protection, and US access to the South Korean insurance markets. [REDACTED]

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The United States has already initiated actions against Seoul under Section 301 of the Trade Act of 1974, and South Korea has made some concessions in response. However, nettlesome problems--such as import liberalization--remain, and further sanctions are possible if negotiations stall or exports to the United States continue to rise sharply. Additional US trade action, such as legislation to restrict imports, would have a strong adverse impact on South Korean trade performance over the medium-term. [REDACTED]

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Foreign competition is also likely to intensify as South Korea continues to diversify its export base. Seoul is reducing its dependence on light manufacturing as it loses competitiveness with countries such as India and Bangladesh, and is expanding production of

knowledge- and technology-intensive industries such as electronics and transport equipment. However, even though South Korea has a labor cost advantage, competition in these areas with countries such as Japan and Taiwan is likely to be fierce, which could dampen South Korean export growth in the medium term. [REDACTED]

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Debt Service Needs and New Credit Availability

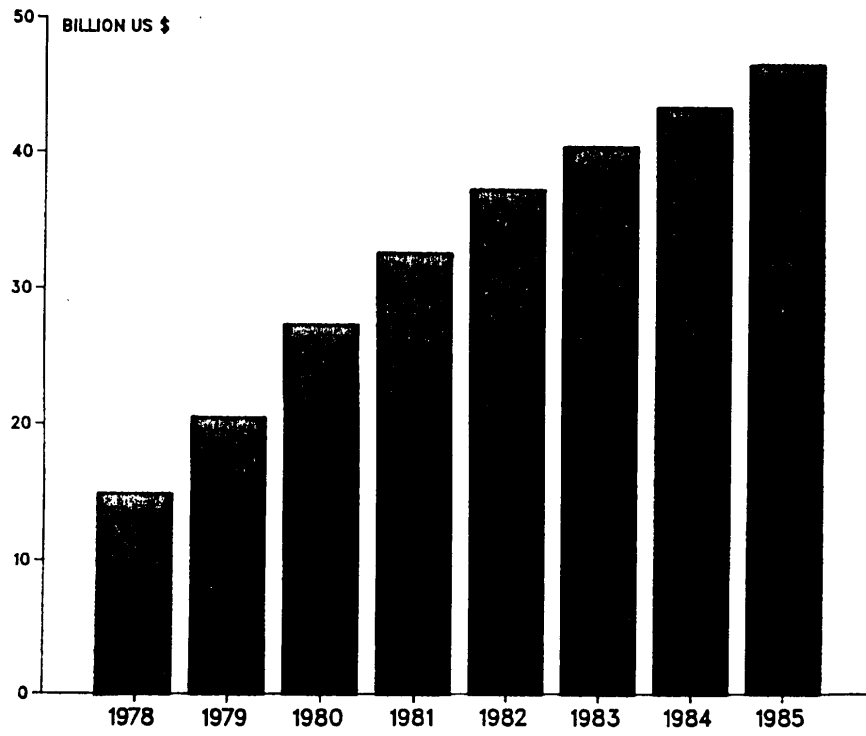
South Korea's debt situation has shown substantial improvement in recent years with the rate of debt increase declining from a high of 37 percent in 1979 to around 5 percent in 1984 (figure 3). In addition, the use of short-term debt has been sharply curtailed. While debt rose an estimated 7 percent last year--\$1.2 billion above its planned limit-- this reflected problems with the commercial banking system and economic pump-priming measures, as Seoul relaxed its heretofore austere monetary and fiscal policies in response to last year's poor economic performance. Overall, the South Korean debt service ratio (including short-term payments) stands at 70 percent. Under the current five-year plan, Seoul is committed to reducing the growth of debt and lowering the debt service burden. [REDACTED]

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Our analysis indicates that under the baseline scenario, debt service payments should remain manageable over the 1986-90 period. Restraint in the growth of debt and use of short-term credit implies slower growth of debt service than in past years. Moreover, under

FIGURE 3

SOUTH KOREAN FOREIGN DEBT,^A 1978-85



A. INCLUDES SHORT TERM

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baseline assumptions export growth should rise from last year's depressed rate, and outstrip increases in debt service payments. As a result, the debt service ratio (including short-term payments) should decline over the medium-term to 44 percent by 1990. [REDACTED]

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Seoul is likely to have little difficulty obtaining external financing. Korea has easy access to external credit--unlike most other LDC debtors--and foreign creditors regard South Korea as one of the best risks among LDC borrowers. Under baseline assumptions, we see little likelihood that this attitude would change significantly. However, bankers' confidence in Korea rests largely on a rate of export growth that outpaces the growth of debt. Should export growth falter and debt continue to rise, bankers may become skittish about adding to their exposure and could offer poorer terms of repayment.

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Impact on Imports and Economic Growth

Under our baseline export scenario, we believe South Korea will be able to increase real imports at a rate that should allow domestically-acceptable rates of real income growth. To reach this assessment, we used a methodology (table 2) that linked: our expectations for export growth, our figures for debt service payments, our estimate of the services balance (excluding interest payments), an assumption that the level of new credit extended to South Korea

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Table 2

South Korea: Projected Growth of Import Capacity Under Alternative Scenarios, 1985-90

	Billion US \$					
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Baseline Export Growth						
Exports	26.5	28.9	32.5	37.0	42.5	48.6
Plus: Gross borrowing	17.8	17.2	17.5	18.4	18.8	19.4
Plus: Other services balance	1.0	1.5	1.5	1.5	1.5	1.5
Less: Debt service ^a	18.6	18.9	18.9	20.0	20.5	21.3
Less: Change in foreign exchange reserves	0.3	0	0	0	0	0
Balance (import capacity)	26.4	28.7	32.6	36.9	42.3	48.2
Change in import capacity (percent over previous year)	--	8.7	13.6	13.5	14.6	13.9
Recession Scenario						
Exports	26.5	28.8	30.2	34.0	38.5	44.0
Plus: Gross borrowing	17.8	17.2	17.5	18.4	18.8	19.4
Plus: Other services	1.0	1.5	1.5	1.5	1.5	1.5
Less: Debt service ^a	18.6	18.9	18.9	20.0	20.5	21.3
Less: Change in foreign exchange reserves	0.3	0	0	0	0	0
Balance (import capacity)	26.4	28.6	30.3	33.9	38.3	43.6
Change in import capacity (percent over previous year)	--	8.3	5.9	12.3	13.0	13.8

^aFigures include short-term payments.

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remains constant at the 1985 level, and an assumption that foreign exchange reserves remain unchanged at this year's level. We then used these estimates of import capacity to assess the potential strength of future economic growth. [REDACTED]

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Based on this analysis, we forecast nominal import capacity to rise nearly 13 percent per year on average, with real import gains averaging around 7.7 percent per year, compared with growth rates of 20.5 percent and 12.5 percent per year respectively during 1970-84. Lower export growth will be the main factor contributing to the import slowdown. With foreign exchange reserves at about \$8 billion (about four months import coverage), South Korea would need to substantially increase foreign borrowing in order to boost import growth, which we do not believe would occur given Seoul's concern over the size of South Korean debt.³ [REDACTED]

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To predict the pace of future real income gains, we made use of the relationship between real imports and real income. Most developing countries--South Korea included--strongly depend on imports to fuel consumption and investment. The ratio of real imports to real GNP has risen over the past decade, reflecting South Korea's growing import dependence. We believe that over the medium term the South Korean authorities will institute measures--such as import substitution in the machinery and cattle feed areas--to curb the dependence on imports and bring the import/GNP ratio down. However,

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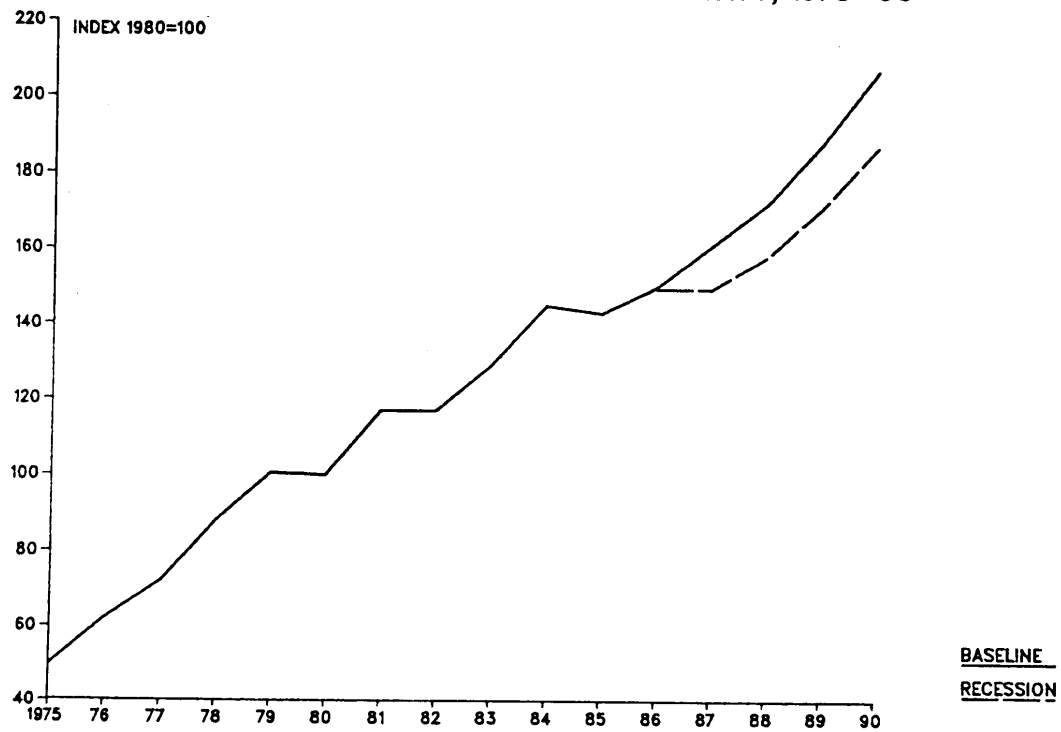
A drop in the price of oil to \$20/bbl would reduce South Korean oil imports by \$1.4 billion per year according to our estimates, providing a substantial boost to Korea's ability to import other crucial industrial inputs. [REDACTED]

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FIGURE 4

SOUTH KOREA: PROJECTED REAL IMPORT CAPACITY, 1975-90^A



A. ACTUAL REAL IMPORTS, 1976-85.

it is unlikely that these steps will be sufficient to completely offset the impact of lower real import growth on real GNP. []

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Given these assumptions we forecast a modest rate of real GNP growth over the next five years. Real GNP gains could average about 6 percent per year over the 1986-90 period under our baseline scenario, lower than the average annual growth rate of 8.3 percent between 1970 and 1984, but an improvement over last year's estimated 4 to 4.5 percent real growth rate. []

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Political and Social Impacts

The slowdown in economic growth this year has not significantly weakened Chun's grip on power. Chun has deflected much of the criticism aimed at his economic policies by pointing to cyclical factors, an upsurge in protectionism, and slack world demand for Korea's exports. The opposition has failed to capitalize politically on the weak economy--largely because it has no economic agenda of its own--confining its policy prescriptions to the argument that long-term economic development and stability depend on progress toward democratization. []

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With real GNP growth forecast to pick up over the rest of the decade, we feel that the economy will become a less contentious issue, although problems will remain. Economic growth is likely to no more than match the 6 to 7 percent rate needed to absorb new entrants into

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A Worst Case Scenario: OECD Recession

South Korea strongly depends on the developed countries for export earnings, shipping 70 percent of its exports to the OECD. Thus, a drop in OECD real income growth, such as occurred in 1982, would reduce export gains, leaving South Korea with less foreign exchange to meet debt service payments and boost import growth. To quantify the impact of a recession in developed countries on South Korean exports, we modified the baseline scenario so that OECD real GNP growth falls to 1.5 percent this year and minus 1 percent in 1987, recovering to 1.5 percent in 1988 and 3 percent per year thereafter.

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The results indicate that South Korean export earnings would be reduced \$14 billion over the 1986-90 period (table 2), which would adversely affect imports and real GNP growth. The average annual real import growth rate over the period would drop by over 25 percent, with the sharpest impact on imports in 1987 (figure 4). Our forecast of real income growth would be reduced by 1 to 1.5 percentage points per year.

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Under these circumstances the domestic situation would become more troublesome. The government economic management team would need to maneuver between policies to reignite the economy without increasing inflation or imposing drastic measures. Higher unemployment and pressures to protect South Korean markets would become focal points for discontent and could figure prominently in unifying opposition forces. An alternative would be a large increase in external borrowing to boost imports and avert an economic slowdown. However, given slower export growth lenders could become reluctant to extend large amounts of new credit in a one of the few LDC markets considered safe. Higher borrowing would also be contrary to Seoul's efforts to reduce the rate of debt accumulation and ease the debt service burden.

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the labor market. Unemployment--particularly among college graduates--will remain an exploitable issue for the political opposition. However, it is unlikely that economic issues will become so serious as to provoke a dramatic confrontation between the Korean government and the opposition. [REDACTED]

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Implications for the United States

The interaction between economic performance and political developments in South Korea, in our view, will be an increasingly important factor shaping US-South Korean relations. Trade issues are likely to remain the most contentious issue between the two countries. Chun's reorganization of the cabinet in January apparently signals his continued backing for the proponents of liberalization, and is significant in light of the economic slowdown and rising domestic tensions over US-Korean trade. If opponents of liberalization can be held off until the economy revives, additional progress on liberalization will proceed step-by-step. [REDACTED]

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Nevertheless, a proliberalization policy carries risks that could weaken the influence of advocates of market opening. Chun's fears of a union of student and labor dissidents will only deepen and push Seoul to dig in on trade policy if pressure from Washington to liberalize coincides with another downturn in growth. In fact many in Seoul are already arguing that they need not open markets as wide as

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Washington wants because of the "special" relationship--an argument that will become increasingly alluring if economic and political conditions deteriorate.

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Appendix

Methodology

Determination of Export Trends

We obtained estimates for exports through econometric analysis, based on export data from 1969-85. Real (inflation-adjusted) exports were assumed to depend on OECD real GNP and the real exchange rate. A jump in OECD real GNP increases the demand for imports, boosting South Korean exports. A decrease in the real exchange rate implies an improvement in the competitive position of South Korea against its major trading partners, thereby increasing exports. We also allowed for a lag in the response of export demand to changes in OECD real GNP or exchange rates.

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We calculated the real--price adjusted and trade weighted--exchange rate by taking ratio of South Korea's wholesale price index to the trade-weighted average of the corresponding price indexes of Seoul's 16 major OECD trading partners, and multiplying this figure by the ratio of the index of the trade-weighted average of the trading partner's dollar-exchange rates to the index of South Korea's bilateral dollar exchange rate. The base year for our calculations was 1980. The calculated real exchange rates provide a measure of recent changes in competitiveness. With OECD real GNP and the real exchange rate determined, real exports were derived.

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The export price index (in terms of US dollars) was taken to be equal to South Korea's wholesale price index divided by the bilateral dollar exchange rate index. The base year for these indexes was 1980. The wholesale price index was used because it includes a wide variety of tradeable or potentially tradeable goods. The export price index was then multiplied by the estimate of real exports to obtain South Korean export earnings in terms of US dollars.

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Exports Under Alternative Scenarios, 1986-90

To determine the influence on key debtor exports of changes in OECD real GNP and key debtor real exchange rates, we calculated export growth for the period under several alternative scenarios for real GNP and exchange rates. The results indicate that movements in OECD real income exert considerably stronger influence than movements in real exchange rates. Therefore, we decided to concentrate on the effects of changes in OECD real GNP on key debtor exports, using two scenarios:

--The baseline case, assuming OECD real GNP growth of 3 percent per year annually and changes in real exchange rates consistent with private forecasts.

--The recession scenario, assuming real GNP growth of 1.5 percent in 1986, minus 1 percent in 1987, 1.5 percent in 1988, and 3 percent per year in 1988-90.

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